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SUBJECT: Structures and Trends in German Banking Industry:
Bleak Outlook Gets Better; Consolidation Scenarios For A
Financial Stronger System

T-IA-F-05-018

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Stability Pact Revision: Art Imitates Life

Ref: (a) Warsaw 1108; (b) Warsaw 1624

1. (SBU) Summary: There is a lively debate about whether the relatively poor performance of the German banking sector is related to its "three pillar" structure of (1) private commercial, (2) public state and savings, and (3) cooperative banks. The discussions were triggered by the continuing weak performance of the German banks relative to other European banks. Although German banks are slowing recovering, the very large German banks no longer rank among the top tier European banks.
2. (SBU) The German Council of Economic Advisors' examination of this structural question found no clear answers. A more recent Frankfurt University study suggests that German banks have not been able to generate increases in revenues as much as their EU competitors nor have they priced credits according to risk, both attributed to the intense competition offered by public savings and cooperative banks.
3. (SBU) Changes are underway in the German banking sector, but none that would suggest an overhaul of the current system. Consolidation will continue, but the key question is how. Current market wisdom is that consolidation will continue as in the past, taking place within the pillars. The IMF asserted that opening up consolidation across pillars would allow for market-oriented solutions for developing profitable products. Even if some local laws were changed to permit this, large banks are unlikely to develop a robust national retail network by snapping up random sales of a few regional savings institutions. Cross border mergers could be another avenue, but also unlikely at this juncture. More intriguing would be the possibility for increasing competition with savings banks that arguably are structured and perform as though they are one large banking entity. If such competition were to alter the present German banking system, the Frankfurt University study suggests such changes would come quickly. Time will tell. End Summary.

Structure of the German Banking System

4. (SBU) The German banking system is characterized as a bank-based financial system composed of three pillars. Bank-based means that enterprises, and households, finance themselves via bank credits rather than via the capital market. The balance sheet total of all German banks is roughly three times German GDP, extremely high compared to other European countries. The three pillars are private credit banks (big banks and regional banks), public banks (savings banks and State banks) and cooperatives (local and central cooperatives).
5. (SBU) Although the private credit banks are individually large, together they account for a market share of 16% in terms of total balance sheet. Savings banks and their regional lead institutes, the State banks, have a market share of more than one third. By law, the business policy of the savings banks is to provide financial resources to the population. Thus, more than one third of total assets in Germany is not managed by economic objectives such as profit maximization. The market of savings banks is locally restricted according to the so-called "regional principle." Cooperative banks have a

market share of approximately 12%. Cooperatives are distinguished from other banks by the fact that their customers are also the owners of the banks by means of share certificates. Apart from that, cooperatives act like savings banks as they do their business on a locally restricted market and profit from co-operation among themselves.

Situation of German Banks: From Bleak to Better

16. (SBU) German banks have endured difficult conditions, suffering from an increasing number of credit losses as a result of the economic downturn, stock market collapse, and a record high number of insolvencies. The return on capital of German banks fell sharply in 2003 to 0.73% from 11.2% in 1999. Profitability has developed quite differently in the three bank groups: Big banks, state banks and central cooperatives recorded a severe reduction of earnings, with negative returns on capital ranging from 4-6%, while savings banks and local cooperatives increased their profit for the financial year experiencing a return on capital of 11%.

17. (SBU) One reason savings banks and local cooperatives turned out good results is because they are anchored in retail banking, deriving most of their income from net interest earnings. Only a small part of their revenues are from more volatile activities, such as trading or fee-based business. In contrast, several years ago the big banks shunned retail activity and concentrated on investment banking. The result is well known: large banks destroyed a considerable amount of their economic value, relegating most of them to the second tier of European banks.

18. (SBU) The German Bundesbank expects an improvement of the bank's earnings performance in 2004 and 2005 during the anticipated economic upturn. Improved earnings are likely as many banks have introduced cost reduction programs in recent years that are now showing results. Apart from that, value adjustments taken in 2003 will decrease risk provisions for the credit business for 2004 and 2005. The outlook for revenues is still uncertain, being dependent on the economic cycle and trading business. These potential improvements do not disguise the fact that the return on capital of German banks is very low in both historical and international comparison.

Does the Weak Performance Stem from the German Banking Structure?

19. (SBU) In its 2003 Financial System Stability Assessment of Germany the IMF posited the thesis that the tree-pillar-structure of the German banking system causes an inefficient use of resources. The German Council of Economic Advisors investigated this thesis in its annual report for 2005. They found that the density of branches in Germany is very high compared to other banking systems, but that the savings banks and the cooperatives profit from their respective co-operation in core activities that allows them to realize economies of scale. Thus, the Council concluded that the number of branches per inhabitant does not throw light upon the efficiency of the German banking system.

10. (SBU) The Council considered that the high incident of mergers between German banks implied an inefficient use of capital. On the other hand, competition in banking appears to be keen, which should instill efficiency. The five biggest institutes possess 22% of total assets, low by international comparison, suggesting contestability of the market. Apart from the U.S. with a concentration level of 24% and Italy with 27%, in all other big industrialized countries the largest banks enjoy concentration levels between 40% and 90%. This result changes if savings banks and cooperatives are no longer treated as separate, autonomous units, but a single banking group. If all savings banks and State banks were counted as one banking group, the Council reckons it would be the largest credit institute in the world. The market share of the five biggest institutes would amount to 67% of total assets, suggesting lower levels of competition.

11. (SBU) A January 2005 study by the Frankfurt University suggests that the structure of German banking may have hindered its overall profitability. While German banks have been able to reduce total operating expenses over total assets, out-performing other EU banks, they have not been able to generate nearly as much revenue growth as their EU competitors from both interest as well as non-interest income. In addition, loan loss provisions in Germany have remained high while declining in other EU banking systems. High provisions combined with declining interest margins imply that, on average, German banks have not priced credit risk appropriately, according to the study. Low revenues and lower interest margins suggest robust competition - good for consumers but not good for banks' profitability. These results are a function of the large market share commanded by the public savings bank and cooperative banks.

12. (SBU) The three-pillar system has been resistant to change. That does not mean that there are no changes afoot in the German banking industry. Among the changes anticipated this year are:

Continuation of consolidation. The number of banks has declined from 4,543 in 1987 to 2,466 in 2003 and the number of branches per 100,000 people has declined from 65 to 46 over roughly the same time period. Much of that consolidation has taken place within the cooperative bank sector. For example, since 1999 the number of banks in Germany has declined by 769, the number of cooperative banks dropped by 640 to 1,392. The savings bank sector also shrunk according to the number of savings banks by 89, bringing the total number of savings banks to 489 at the end of 2003. These consolidations reflect financially larger or stronger neighboring co-operative or savings banks taking over weaker institutions.

Designation of a new "big bank." The Post Bank that was recently privatized will be designated as a "big bank," bringing the total number to five. The Post Bank is substantially different from the other large banks as it has an extensive branch network that covers the entire country and concentrates in the retail sector.

More lending to retail and SME's. Big banks have shifted their focus to give more attention to retail sector and SME lending.

State banks to adopt and refine new business models. This adjustment is underway as these State banks seek ways to continue operations without State guarantees. Some are merging with other state banks, others are seeking new investors or spinning off their commercial operations from the public lending activities. Private banks have argued that the credit rating of these institutions would weaken absent the state guarantees, driving up their financing costs and making them less competitive. However, preliminary judgments by credit rating agencies suggest very little deterioration in the State banks' creditworthiness so far. Retaining these ratings will depend on successful implementation of their new models.

Increased competition in bond issuance business. This will result from the new law on Pfandbrief (bonds backed by mortgages or public assets). The law will allow all banking institutions to issue such instruments, not just mortgage banks and public law banks. Pfandbrief issuance had been a growing activity, leading Finance Ministry officials believe that the legal change will contribute to more bank consolidation. Bundesbank officials, however, believe the market will not be as robust as before, implying that opening up competition will not have a significant influence on the banking structure. Better pricing of credits to risks. The new risk-based Basel II capital requirements, likely to be adopted by the European Parliament before the end of the year, should result in more risk-sensitive pricing of credits. While this indicates higher credit costs for some borrowers in the future, as the Frankfurt University study indicates, the pricing of credits has been too low relative to banking risks. This suggests that interest rate margins should increase.

Consolidation Scenarios

13. (SBU) The notion that the predominance of public savings institutions is an impediment to consolidation and strengthening of the overall German banking sector was given support by the IMF. In its report on Germany's banking sector, IMF staff declared, "a reduction in existing legal and other barriers to restructuring, within or across pillars, would expand the scope of possible market-oriented solutions." Another IMF study shows that other countries that underwent banking sector restructuring witnessed an increased role by private banks, accompanied by financial strengthening. This has intensified the debate about the reforms of public sector banks.

14. (SBU) It is controversial whether a high participation of the government and the States are good or bad for the German banking system. Supporters of reforms cite efficiency losses for the whole system due to the public participation. Moreover, in their opinion, government intervention cannot be justified from a regulatory point of view since there is no market failure. Reform opponents, on the other side, deny efficiency losses, referring to the

high return on capital of the savings banks. They point out that the predominance of profitable savings banks in Germany mirrors the structure of German industry to which these banks lend, i.e. small and medium size "middlestand" firms that are widely dispersed throughout the country.

15. (SBU) While many other European countries have experienced successful restructuring of their banking systems, the German situation is different in its remarkable resistance to change. Whether this is due to the political inability to take necessary reforms or because the existing system, after weathering a heavy storm, is not so bad and fills a need, are discussable points. However, it is true that local politicians are reluctant to give up controls over their local financial institution on which they can rely for local lending and jobs. On the other hand, if the savings banks are so good, then why should they be protected from competition by laws that restrict their ownership? The Frankfurt University study differs from the IMF view in asserting that academic research does not make an a priori case for private banks, driven by shareholder value, as delivering superior performance in terms of growth and welfare, than public banks.
16. (SBU) Consolidation of the banking sector will continue and, most likely, contribute to its gradual strengthening. There are several consolidation scenarios.
 - A. Within pillars: Savings and cooperative banks would continue to consolidate among themselves as weaker institutions are absorbed by larger neighboring institutions, exploiting economies of scale through having one central location provide back office functions. Mergers among large private banks appear less attractive as they cannot realize greater economies of scale, would face costs of redundant branch networks, and have little influence on the institution's overall competitiveness in light of the large market share commanded by public institutions.
 - B. Across pillars: In some German states reform proposals were made on the back of the bad financial situation of the lender and communes. The fact is, that the laws on savings banks in the individual lender allow for different participation schemes of private institutions or persons at the public institutions. One case that attracted attention was the attempt of the mayor from Stralsund to sell the savings bank of Stralsund. In the end this was prevented by the state government of Mecklenburg-West Pomerania by a change of legislation. A recent example is the planned takeover of the Bank of Berlin (a private bank) by the Berliner Volksbank (a cooperative) and the Mittelbrandenburgische Sparkasse in Postdam (a savings bank). Such approaches to cross-pillar consolidation would be piecemeal, at best. If a large private bank were to purchase such a savings bank, it would likely face intense competition as savings institutions from neighboring areas would move into the region. Account holders fiercely loyal to savings institutions would shift accounts away from the procured thrift to the new one. As one expert commented, private banks would find themselves in deeper competition than before, like "bailing water with a fish net."
 - C. Product Consolidation: Rather than merging entire organizations, banks will join together to realize economies of scale by having joint products (like mortgages) or back office operations.
 - D. Cross Border Mergers or Acquisitions: The European Central Bank's 2004 Report on EU Banking Structure points out that since the flurry of M&A activity in the run up to the adoption of the euro, M&A activity has been subdued and primarily confined to domestic consolidation. However, in light of increased liquidity in the sector and the increased concentration of domestic markets, cross border M&A activity may increase. Higher fixed investments associated with IT costs, more transparent accounts under the EU adopted International Accounting Standards, and the need to make more efficient use of capital under Basle II are other reasons that could drive such activity. Although there has been a significant number of cross-border M&A activities in Germany, something on the scale that would alter the German banking landscape seems improbable at this time. The large private banks do not appear to be attractive candidates for purchase, as suggested by weak revenue performance, low market share, and limited possibilities to trim costs. Again, the dominant position of savings and cooperative banks makes foreign entry into the German banking difficult.
 - E. Increased Competition to Savings Banks: As noted above, the Economic Council hypothesized that if the savings banks were counted as one group, they would be the largest bank in Germany and the world. The Frankfurt University study notes that the 482 public savings banks operate on the "regional principle," not engaging in competition between regions. State banks and Dekabank provide them services that enable individual savings bank to realize economies of scale. Considered from this point of view, German competition

authorities should take a hand in breaking up what appears to be collusive market behavior, in the view of one banking expert, an unlikely prospect. Alternatively a savings bank from another EU country could seek to crack the domestic German market by not respecting the regional principle. Or perhaps the Post Bank would adopt a more assertive strategy in its lending businesses.

17. (SBU) A combination of many if not all of these scenarios should play out in the coming years. The Frankfurt University study holds out a tantalizing thought. It suggests that the current banking structure of the savings banks relies on complementary elements, like the regional principle or reliance on economies of scale. Since such a system has strong dependencies, gradual changes produce at least temporary welfare losses. To their mind, this suggests that if the system breaks down, the banking system "will inevitably also undergo far-reaching structural changes." Even more tantalizing is their last thought: "We cannot rule out that this might happen soon." Time will tell.

18. (U) This message has been coordinated with US Embassy Berlin.

19. (U) POC: James Wallar, Treasury Representative, e-mail wallarjg2@state.gov; tel. 49-(69)-7535-2431, fax 49-(69)-7535-2238

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